DEPARTMENT OF STATE REVENUE

SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 06-0238
Sales and Use Tax
For Tax Years 2002-04

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ISSUE

I. Sales and Use Tax—Manufacturing

Authority: *General Motors Corporation v. Indiana Department of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991); IC § 6-2.5-5-5.1; IC § 6-2.5-13-1; 45 IAC 2.2-4-13; 45 IAC 2.2-5-8; 45 IAC 2.2-5-12

Taxpayer protests the assessment of sales and use tax.

STATEMENT OF FACTS

Taxpayer is a manufacturer with operations in several states, including Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for sales and use tax. Taxpayer protested a portion of these assessments, a hearing was held and a Letter of Findings was issued. Taxpayer requested a rehearing to discuss new information it provided. A rehearing was held and this Supplemental Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax—Manufacturing

DISCUSSION

Taxpayer protests the inclusion of several items as taxable on the Department's audit. The first Letter of Findings sustained Taxpayer's protest on some of the items and denied the protest on some of the items. As part of the request for rehearing, Taxpayer provided additional documentation in support of its position. The first issue protested in this Supplemental Letter of Findings is the taxable status of wrapping machines. 45 IAC 2.2-5-8(a) provides:

> In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. The exemption provided in this regulation [45 IAC 2.2] extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

Taxpayer protests that the wrapping is part of the production process and the machines are therefore exempt. Taxpayer refers to 45 IAC 2.2-5-8(d), which states:

> Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.
>
> –EXAMPLE–
>
> (1) The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing steps, through packaging, qualify for exemption. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax.

Taxpayer states that the wrapping prevents damage to the product and complies with its customer's demands to keep the product dry until installation. Taxpayer believes that the production process does not end until the metal building components are wrapped as required by its customers.

The Indiana Tax Court has addressed the taxability of wrapping/packaging materials and equipment. In *General Motors Corporation v. Indiana Department of State Revenue*, 578 N.E.2d 399 (Ind. Tax Ct. 1991), the Department argued that wrapping materials used to protect parts in transportation from one General Motors plant to another were taxable since marketable products had been produced and the Department considered the production process completed. The court explained:

> The end of an integrated production process is not signaled by the production of unfinished work in process merely because it is potentially a finished marketable product. An integrated production process terminates upon the production of the most marketable finished product, e.g., the product actually marketed. Consequently, GM's manufacture of finished marketable automobiles is accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants is an essential and integral part.

Id. at 404.

In the instant case, the product actually marketed is the metal building component. Therefore, as explained in *General Motors*, the integrated production process terminates upon the production of the most marketable finished product, which is metal building components. The wrapping materials are applied after the components are completed and are ready for shipping. This does not make the product more marketable, but merely maintains the marketability post-production. While Taxpayer's customers may require protection for the components, such protection is not part of the production process and the wrapping machines used in providing such protection are not eligible for the exemption found at 45 IAC 2.2-5-8.

Next, Taxpayer protests that some of its forklifts and a proportionate amount of the propane the forklifts run on are used for some exempt purposes. The Department assessed use tax on the purchase of forklifts and propane used to operate forklifts on the basis that the forklifts were used for non-production purposes. 45 IAC 2.2-5-8(f)(5) provides guidance in this situation. 45 IAC 2.2-5-8(f) explains:

> (1) Tangible personal property used for moving raw materials to the plant prior to their entrance into the production process is taxable.
> (2) Tangible personal property used for moving finished goods from the plant after manufacture is subject to tax.
> (3) Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.
> (4) Transportation equipment used to transport work-in-process, semi-finished, or finished goods between plants is taxable, if the plants are not part of the same integrated production process.
>
> –EXAMPLES–
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> (1) A manufacturer of clay pipe uses forklift tractors to transport the pipe from the machine in which it is formed to the kiln. The forklift tractors are exempt.
> (2) A metal and alloy manufacturer pulverizes raw materials for use in an exempt furnace. Weigh bins are utilized for the temporary storage of the exempt materials after pulverization and prior to use in an exempt furnace. Transportation equipment used to transport the pulverized raw material to and from the weigh bins is exempt.
> (3) A forklift is used exclusively to move work-in-process from a temporary storage area in a plant and to transport it to a production machine for processing. Because the forklift functions as an integral part of the integrated system comprising the production operations, it is exempt.
> (4) A forklift is used exclusively to move finished goods from a storage warehouse and to load them on trucks for shipment to customers. The forklift is taxable because it is used outside the integrated production process.
> (5) *A forklift is regularly used 40% of the time for the purpose described in Example (3) and 60% of the time for the purpose described in Example (4). The taxpayer is entitled to an exemption equal to 40% of the gross retail income attributable to the transaction in which the forklift was purchased.*

(Emphasis added.)
….

Also, 45 IAC 2.2-5-12 provides:

(a*) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining*.
(b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.
(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process or in mining, provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.
(d) Pre-production and post-production activities.
(1) Direct consumption in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required.
(2) "Direct use in mining" begins with the drilling of the shaft or well or the first removal of overburden in surface mining or quarrying. It ends when the item being mined or extracted has been physically removed from the mine, well, or quarry.
(e) "Have an immediate effect upon the article being produced or mined." Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations [45 IAC 2.2].
(f) Other taxable transactions. Purchases of materials consumed in manufacturing, processing, refining, or mining activities beyond the scope of those described in subsection B above [subsection (e) of this section] are taxable. Such activities include postproduction activities; storage step) [sic.]; maintenance, testing and inspection (except where in direct production); (except where essential and integral to the process system); management and administration; sales; research and development; exhibition of products; safety or fire prevention; space heating; ventilation and cooling equipment for general temperature control; illumination; shipping and loading.
(g) "*Consumed" as used in this regulation [45 IAC 2.2] means the dissipation or expenditure by combustion, use, or application and does not mean or include the*

> *obsolescence, discarding, disuse, depreciation, damage, wear or breakage of tools, dies, equipment, machinery, or furnishings.*
> (Emphasis added.)

Taxpayer has five twelve thousand pound forklifts and nine six thousand pound forklifts, along with two side loaders. Taxpayer's documentation explains that one twelve thousand pound forklift is used ninety percent of the time to move work in progress and another twelve thousand pound forklift is used fifteen percent of the time to move work in progress. The remaining forklifts and side loaders are used in pre-production or post-production, which does not qualify for the exemption.

Regarding the forklifts themselves, a review of the audit report shows only the purchase of several six thousand pound forklifts during the audit period, not the twelve thousand pound forklifts which were partially used for exempt purposes. Since the six thousand pound forklifts are used exclusively for pre-production or post-production purposes, they are not eligible for the exemption found in 45 IAC 2.2-5-8, and tax was properly imposed on the purchase of these forklifts.

Since all of the forklifts and side loaders run on propane, and since some of the forklifts are partially used for exempt purposes as provided in 45 IAC 2.2-5-12, some of the propane is used for exempt purposes. The available documentation does not indicate the actual propane usage for the various forklifts; therefore, the exempt percentage of propane will be calculated by averaging the exempt use for the two twelve thousand pound forklifts (ninety percent exempt use and fifteen percent exempt use respectively) among the sixteen lifts and loaders using propane. This results in 6.5625 percent exempt propane purchases.

Next, Taxpayer protests that it predominantly uses the electricity it purchases for manufacturing purposes, and is therefore eligible for the one hundred percent predominant use exemption. That exemption is found at 45 IAC 2.2-4-13(e), which states:

> Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50[percent]) of the utility services and commodities are consumed for excepted uses.

The Department explained in the first Letter of Findings that, since some machinery listed as non-exempt in the audit report had been reclassified in the Letter of Findings as exempt, the calculations for electrical usage would need to be recalculated to determine if the usage rose above the fifty percent threshold required by 45 IAC 2.2-4-13(e). In the rehearing request, Taxpayer included the electrical usage study it referred to in its initial protest.

A review of the audit report shows that the Department decreased the number of hours credited to each piece of exempt machinery in order to more fairly reflect the amount of electricity used in production. 45 IAC 2.2-4-13(b) provides:

> The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. *Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1*
> (Emphasis provided.)

IC § 6-2.5-5-5.1 provides:

> (a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.
> (b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

One of the Department's reasons for decreasing the amount of time considered exempt was due to warm-up prior to manufacturing activities. In this sense, the Department is correct. Warm-up, however necessary it may be, is not direct production of tangible personal property, and is not exempt under 45 IAC 2.2-4-13(b). In the rehearing, Taxpayer claimed that the Department did not provide enough detail for all of the reductions it made, and did not give any credit for overtime, or multiple shifts at Taxpayer's plants. After reviewing the new documentation, it can be determined that Taxpayer did meet the fifty percent threshold for predominant use of electricity in manufacturing, and so does qualify for the exemption found at 45 IAC 2.2-4-13(e).

The last item is the lease/rental of trucks for delivery of its product. As the initial Letter of Findings explained, the relevant statute is IC § 6-2.5-13-1(f), which states:

> The lease or rental of motor vehicles, trailers, semitrailers, or aircraft that do not qualify as transportation equipment, as defined in subsection (g), shall be sourced as follows:
> (1) For a lease or rental that requires recurring periodic payments, each periodic payment is sourced to the primary property location. The primary property location shall be as indicated by an address for the property provided by the lessee that is available to the lessor from its records maintained in the ordinary course of business, when use of this address does not constitute bad faith. This location shall not be altered by intermittent use at different locations.

> (2) For a lease or rental that does not require recurring periodic payments, the payment is sourced the same as a retail sale in accordance with the provisions of subsection (d).
> This subsection does not affect the imposition or computation of sales or use tax on leases or rentals based on a lump sum or accelerated basis, or on the acquisition of property for lease.

The initial Letter of Findings determined that the leased trucks sitused out-of-state were not subject to use tax. The initial Letter of Findings also limited the exemption to those trucks for which Taxpayer had provided documentation establishing that the situs was indeed outside Indiana. As part of the rehearing process, Taxpayer provided more documentation for more trucks. This documentation will be included in a supplemental audit in the same manner as determined in the initial Letter of Findings.

In conclusion, the wrapping machines are not part of the production process, as explained by *General Motors*, and are not exempt under 45 IAC 2.2-5-8. The forklifts purchased during this period were not used in exempt activities, and are not exempt under 45 IAC 2.2-5-8. The propane purchased during this period was partially used in exempt activities, and the assessment on propane purchases will be reduced by 6.5625 percent. Taxpayer has provided sufficient documentation to determine that it is entitled to the predominant use exemption found at 45 IAC 2.2-4-13(e). The additional documentation regarding leased trucks sitused out-of-state will be taken into account in a supplemental audit.

FINDING

Taxpayer's protest is sustained in part and denied in part.

WL/BK/DK June 19, 2007